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EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND FRANCE

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON AUGUST 9, 1988

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed supplementary protocol to the income tax treaty between the United States and France. The proposed protocol was signed on June 16, 1988, and was amplified by an exchange of notes signed the same day. The proposed protocol would amend the current U.S.-France income tax treaty, which entered into force on July 11, 1968, as amended by the protocols of October 12, 1970, November 24, 1978, and January 17, 1984 ("the existing treaty"). A public hearing on the proposed protocol is scheduled on August 9, 1988, by the Senate Committee on Foreign Relations.

The primary reason for the negotiation of the proposed protocol was to implement the many U.S. tax policy changes enacted in the Tax Reform Act of 1986 (the "1986 Act") as they affect existing U.S. income tax treaties. For example, the 1986 Act enacted a branch profits tax to be imposed generally on the U.S. business income of a foreign corporation doing business in the United States. Although the existing treaty provides for a branch profits tax, the proposed protocol updates the existing treaty to account for the tax actually imposed by the 1986 Act.

In addition to updating the U.S.-France income tax treaty for the 1986 Act's policy changes, the proposed protocol adds a new exemption from French income tax for certain types of U.S.-related investment income of French residents who are U.S. citizens.

The first part of the pamphlet is a summary of the principal provisions of the proposed protocol. The second part presents a discussion of the issues raised by the proposed protocol. This is followed by a third part containing a detailed, article-by-article explanation of the proposed protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and France* (JCS-14-88), August 8, 1988.

I. SUMMARY

The proposed protocol contains the following modifications to the income tax treaty between the United States and France.

(1) Definition of resident.—The proposed protocol would add France and its local authorities, and the United States and its political subdivisions or local authorities, to the definitions of French resident and U.S. resident, respectively. The provision would implement the intent of a provision of the 1986 Act to treat a foreign government as a resident of its country for treaty purposes so long as it extends reciprocal treatment to the United States.

(2) Definition of business profits.—The proposed protocol would amend the definition of business profits contained in the existing treaty to clarify that the business profits attributable to a permanent establishment that a resident company has in the other country would include any such gain or income where the payments for such gain or income are not received until after the permanent establishment has ceased to exist. This provision would implement a provision of the 1986 Act that treats any gain or income of a foreign person for any taxable year which is attributable to a transaction in any other taxable year as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in the other taxable year.

(3) Dividends.—The proposed protocol would amend the existing treaty to preclude the United States from imposing its dividend withholding tax on dividends paid by French resident corporations which have a certain amount of income attributable to a U.S. permanent establishment. This modification is consistent with the United States imposing a branch profits tax on the U.S. permanent establishment of the French resident. The proposed protocol also would update the definition of dividends to conform with definitions in the 1981 proposed U.S. model income tax treaty ("U.S. model treaty") and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty").

(4) Interest.—The proposed protocol would add to the treaty a rule allowing a treaty country to impose an otherwise allowable withholding tax on interest paid or accrued by a permanent establishment or fixed base in that country as soon as the permanent establishment or fixed base accrues a deduction for the interest.

(5) Royalties.—The proposed protocol provides a new sourcing rule for royalties, clarifies the treatment of royalties beneficially owned by a resident of the United States or France, and adds a rule allowing a treaty country to impose an otherwise allowable withholding tax on a royalty paid or accrued by a permanent establishment or fixed base in that country as soon as the permanent establishment or fixed base accrues a deduction for the royalty.

(6) Capital gains.—Like the amendment to the definition of business profits described above, the proposed protocol would amend the existing treaty to clarify that a country may tax capital gains attributable to a permanent establishment in that country even if the payments on the gains are received after the permanent establishment has ceased to exist.

(7) Branch profits tax.—The proposed protocol would allow the United States to impose its branch profits tax on the business profits attributable to a U.S. permanent establishment that a French resident has in the United States, and would limit both the U.S. and French branch profits taxes rates on residents of the other country to 5 percent.

(8) Relief from double taxation.—The proposed protocol adds a new exemption from French income tax for certain types of U.S.-related investment income of French residents who are U.S. citizens so long as those French residents have demonstrated that they have complied with their U.S. tax obligations. The proposed protocol also requires France to give a tax credit for U.S. branch profits tax paid by French residents.

(9) Anti-treaty shopping provision.—Consistent with certain provisions of the 1986 Act, the proposed protocol strengthens the existing treaty's anti-treaty shopping provision by adding a "base erosion" rule that prevents a resident receiving benefits from the other country from reducing the income base that is subject to tax in the residence country.

II. ISSUES

The treaty as it would be modified by the proposed protocol raises the following specific issues:

(1) Dividends paid by pass-through entities

Under the existing treaty, the maximum allowable rate of tax at source on dividends is 15 percent, or 5 percent in certain cases where the recipient is a corporation that is a "direct" investor; that is, one that (as of the day before the dividend is paid) owned at least 10 percent of the payor's voting stock during the payor's current and prior taxable years. The reduction in rate to 5 percent is not available where the payor received more than 25 percent of its prior year gross income from certain interest and dividends (other than interest derived in the conduct of a banking, insurance, or financing business and dividends or interest received from 50-percent or more owned subsidiaries).

These reductions from the Internal Revenue Code withholding rate of 30 percent are consistent with the U.S. model treaty. They reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5 percent rate reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment. However, there is a concern that these reductions may be inappropriate where the United States is the source country and it imposes little or no corporate-level tax on the payor of the dividend.

A real estate investment trust (REIT) is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. (Code sec. 857(b).) One of those conditions is the requirement that a REIT distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are U.S. source and are thus subject to U.S. withholding tax of 30 percent when paid to foreign owners. Distributions of rental income, for example, are not themselves considered rental income. Like dividends, U.S. source rental

income of foreign persons is generally subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on rental income is generally not reduced in U.S. income tax treaties.

It has always been the United States position to preserve the right to tax income from real property to the country in which the income is derived. Thus, the United States always preserves its right to tax real property income derived from the United States in its income tax treaties.

The Internal Revenue Code also generally treats regulated investment companies (RICs) as both corporations and conduits for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. For this reason, the particular rationale for the 5 percent treaty withholding rate would generally make it inappropriate to apply that rate to the withholding tax on RIC dividends, regardless of the proportion of the RIC's stock owned by the dividend recipient.

In general, the existing treaty would not appear to allow the 5-percent rate on dividends from a RIC because typically more than 25 percent of a RIC's income is interest and dividends not from any banking, insurance, or financing business and not from any 50-percent or more owned subsidiaries. On the other hand, it may be possible for a RIC to fall below this threshold by investing heavily in non-income-producing securities or other assets.

The issue presented by the application of the existing treaty to REITs and RICs is whether dividends paid by a REIT or a RIC should be treated differently from dividends paid by other U.S. corporations. Because REITs generally do not pay any corporate level U.S. income tax, and because a REIT's income often is composed of a type of income over which the United States maintains its right to tax in its treaties, reducing the U.S. withholding tax rate on REIT dividends as under the existing treaty is inconsistent with the purposes of dividend rate treaty reductions. Similarly, because RICs generally do not pay any corporate level U.S. income tax, and because, on a conduit theory, RIC investors are generally "portfolio" investors in the underlying RIC assets, it may be inappropriate to allow taxation of RIC dividends at the "direct" investor withholding rate in those instances (presumably rare) where a RIC's interest and dividend income is below the treaty's 25-percent threshold. Even if it were appropriate to reduce source country taxation of income derived through entities such as REITs and RICs, it may be inappropriate for the United States to do so, in effect, unilaterally. The proposed protocol does not address either concern.

The committee could consider a reservation to the proposed protocol to require a further modification to the treaty's dividend article that would address these concerns. The proposed protocol does not purport to address the dividend withholding rate issue, however. It is understood, moreover, that the Treasury Department considers the application of a 5-percent rate to REIT and RIC dividends to be inapprorpiate. It is further understood that the Treasury Department is willing to initiate negotiations to conform the existing treaty with that view. Because a reservation would consider-

ably delay the benefits to be derived by U.S. citizens under the proposed protocol, the committee could consider the proposed protocol on the understanding that negotiations will be undertaken expeditiously to modify the dividend reductions contained in the existing treaty.

(2) Treaty shoppings

The proposed protocol, and the existing treaty, like a number of U.S. income tax treaties, both generally limit treaty benefits for treaty country residents other than individuals so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed protocol is intended to benefit residents of France and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed to their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax by lending money, for example, to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

Aspects of the anti-treaty shopping provision of the proposed protocol and of the existing treaty differ either from the anti-treaty shopping provision of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the treaty as modified by the proposed protocol effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed protocol is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed protocol (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter, under the proposed protocol. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article conforms to the comparable rule of the U.S. model, but not the comparable rule in treaties negotiated more recently. The general test applied by the U.S. model to deny benefits is a broad one, looking to whether the acquisitions, maintenance, or operation of an entity had "as a principal purpose obtaining benefits under" the treaty. By contrast,

the Treasury has more recently sought in negotiations a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business.

The practical difference between the two tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the trade or business test could be interpreted to require a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the active business test could be stricter than a broad reading of the principal purpose test (i.e., would operate to deny benefits in potentially abusive situations more often).

Moreover, the IRS may find it relatively difficult to sustain a narrow reading of the principal purpose test. (In litigation involving Code section 367, for example, which utilized a principal purpose test until 1985, courts have consistently refused to apply this test to transactions where taxpayers could claim any business purpose.) Given that possibility, it may well be that the test contained in the existing treaty and the proposed protocol will prove less strict than the active business test.

The committee could consider a reservation to the proposed protocol to require a modification to the limitation on benefits article that would replace the principal purpose test with the active business test. As in the case of dividend withholding on REITs and RICs, however, the proposed protocol does not purport to address this issue. Moreover, the differences between the two tests are in some cases not clear-cut, and in any case the Treasury Department has recently shown a preference for adoption of the active business test in treaty negotiations. Because a reservation would considerably delay the benefits to be derived by U.S. citizens under the proposed protocol, the committee could consider the proposed protocol on the understanding that in negotiations undertaken in the future the Treasury will seek to modify the principal purpose test.

III. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and France is presented below.

Article I. Taxes Covered

The proposed protocol would amend the existing treaty to clarify that the U.S. income taxes covered by the treaty are those of the Internal Revenue Code of 1986.

Article II. Definition of Resident

The proposed protocol would add France and its local authorities, and the United States and its political subdivisions or local authorities, to the definitions of French resident and U.S. resident, respectively. Thus, the proposed protocol renders income derived by any of these entities from sources within the other country eligible for treaty benefits. This provision implements a statement in the legislative history of section 892 of the Internal Revenue Code ("the Code") as amended by the 1986 Act, that for treaty purposes, a foreign government is intended to be treated as a resident of its country, unless it denies treaty benefits to the United States. (*See* Sen. Rep. No. 313, 99th Cong., 2d Sess. 418 (1986).)

Article III. Business Profits

Under the business profits article of the existing treaty, industrial or commercial profits of a resident of one treaty country are taxable only in that country unless the resident is engaged in industrial or commercial activity in the other country through a permanent establishment situated in that other country. If the resident is so engaged, the other country may tax only so much of the resident's profits as are attributable to the permanent establishment. The profits attributed to the permanent establishment are those which would be attributable to it if the permanent establishment were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the resident of which it is a permanent establishment.

The 1986 Act provided that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the 1986 Act provided that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade

or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Consistent with the first of these 1986 Act changes, the proposed protocol would amend the business profits article of the existing treaty to clarify that, for purposes of the treaty rules stated above, any income or gain attributable to a permanent establishment that a treaty country resident has in the other country is taxable in that other country even if the payments are deferred until after the permanent establishment has ceased to exist. The proposed protocol would similarly amend the capital gains article to clarify that nothing therein prevents the country in which the permanent establishment is located from taxing the gain permitted to be taxed under the business profits article as it would be amended by the proposed protocol. It is understood that no change to the existing treaty is believed necessary to conform the treatment of income derived from independent personal services with Code section 864(c)(6) as added by the 1986 Act. (See discussion of Article VII of the proposed protocol below.) The proposed protocol does not, however, amend the existing treaty to conform to the rule in Code section 864(c)(7).

The proposed protocol would also insert language into the business profits article to the effect that when an insurance company of one of the countries has a permanent establishment in the other country, reinsurance premiums received shall be taken into account for the determination of taxable profits only in the country of which the company is a resident.

The tax treatment of investment income attributable to premiums covered by the provision is the subject to a Revenue Ruling (Rev. Rul. 77–62, 1977–1 C.B. 414) issued after consultation between the competent authorities of the United States and France. The ruling states that the term "reinsurance premiums" used in the 1967 note shall be viewed as including investment income derived in connection with the conduct of a reinsurance business in one of the contracting states by an insurance company that is a resident of the other contracting state. The Technical Explanation to the proposed protocol states that no inference should be drawn from the proposed protocol's reinsurance provision with respect to the tax treatment of the investment income described above.

Article IV. Dividends

Subject to special rules for permanent establishments and fixed bases, the existing treaty generally prohibits taxation by a treaty country of dividend income derived by a resident of the other country from sources outside the first country. Thus, for example, generally a dividend paid by a French corporation to a French resident is not taxable by the United States (unless the resident is a U.S. citizen). Prior to the 1986 Act, the Internal Revenue Code treated as U.S. source income, and imposed a withholding tax on a portion of, dividends paid by a foreign corporation to foreign shareholders if the U.S. effectively connected gross income of the corporation exceeded a 50 percent threshold over a 3-year period (former Code sec. 861(a)(2)(B)). The 1986 Act amended this source rule and prohibited imposition of this tax in the case of any dividends paid by a

foreign corporation in a year for which it is not exempt from the Code's branch profits tax.

The existing treaty allows a subclass of the dividends described above to be treated as U.S. source dividend income of French residents. In order for dividends to be treated as U.S. source under the treaty, the corporation must have a U.S. permanent establishment and more than 80 percent of the corporation's gross income for a 3-year period prior to the year in which the dividend was declared must have been taxable to the permanent establishment. After the 1986 Act, a foreign corporation is generally subject to the branch profits tax on its U.S. trade or business. Moreover, a French corporation would generally be subject to branch profits tax under the proposed protocol (see discussion of Article VIII below) on any dividend equivalent amount attributable to the permanent establishment for the year in which the dividend was declared. Consequently, under the 1986 Act and Article VIII of the proposed protocol, such a corporation would not be subject to U.S. withholding tax on dividends it pays, even if dividends of that corporation were treated as U.S. source dividends under the existing treaty rule described above.

Consistent with this 1986 Act change, the proposed protocol would delete from the treaty the rule treating as U.S. source dividends those dividends paid by French corporations with 80 percent of their gross income taxable to a U.S. permanent establishment during the prior 3-year period.

The proposed protocol would also add to the treaty, at France's request, a definition of "dividend" for purposes of the treaty's dividend article (Article 9 of the treaty). The definition is largely identical to the definition in the OECD model treaty. Like the U.S. model treaty, the proposed protocol defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. To conform with French law, the term also includes income from "jouissance" shares or "jouissance" rights, mining shares, or founders shares which participate in profits and which are not debt claims. Dividends also include income from other corporate rights which is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest.

Article V. Interest

The existing treaty provides that when a person paying interest has a permanent establishment or fixed base in a treaty country, in connection with which the indebtedness giving rise to such interest was incurred, and such interest is borne by such permanent establishment or fixed base, then the interest shall be deemed to arise in the country in which the permanent establishment or fixed base is situated. The proposed protocol would add that the interest shall be deemed to be paid by the permanent establishment or fixed base to the beneficial owner at the latest when it is taken into account as an expense of the permanent establishment or fixed base. Thus, for example, where a U.S. resident has a permanent establishment in France that accrues interest it owes to a

third country resident, and that interest would be French source income of the third country resident subject to French withholding tax, the proposed protocol would allow France to impose a liability on the U.S. resident for the withholding tax as of the date that the permanent establishment accrues the interest as a deduction for purposes of computing its own French income tax liability.

According to the Technical Explanation, this provision is not to be construed as requiring the beneficial owner of the interest to pay tax to the source country prior to the actual payment of the interest, in circumstances where the payor has failed to remit the tax to that country until after the payor takes the payment into account as an expense. Thus, in the example given above, if the permanent establishment has accrued its interest deduction for French tax purposes without paying the interest to the third country resident and without paying the withholding tax to France, then until the interest payment is actually made to the third country resident, nothing in the proposed protocol is to be construed as imposing liability for the withholding tax on the third country resident.

Article VI. Royalties

The proposed protocol provides a new sourcing rule for royalties, clarifies the treatment of royalties beneficially owned by a resident of the United States or France, and provides a rule governing the latest time when royalties shall be deemed paid.

Source rules

Under the existing treaty, royalties paid for the use of in one of the treaty countries, or for the right to use in that country, patents, designs or models, plans, secret processes or formulae, trademarks, or other like property or rights, or for know-how, are treated as income from sources within that country. The proposed protocol would replace this source rule with a three part test. As under the treaty, the protocol would provide that in all cases royalties paid for the use of or the right to use property in the United States shall be deemed to arise in the United States. However, the proposed protocol would generally source all other royalties by reference to the residence of the payor or to the location of any permanent establishment or fixed base of the payor that bears the royalty and to which the liability to pay the royalty is attributable.

Thus, unless the royalty is for the use of or the right to use property in the United States, royalties would be deemed to arise in a treaty country when the payor is that country itself, a local authority, a statutory body, or a resident of that country. Where, however, the payor of such a royalty (whether or not a treaty country resident) has a permanent establishment or fixed base in a treaty country, the liability to pay the royalty is incurred in connection with that permanent establishment or fixed base, and the royalty is borne by that permanent establishment or fixed base, then the royalties would be deemed to arise in the country where the permanent establishment or fixed base is situated.

According to the Technical Explanation, this change would practically relate only to French tax. Under both the existing treaty and the proposed protocol, French residents generally pay U.S. tax

on royalties they receive only when the royalties are derived from U.S. sources or the right or property giving rise to the royalties is effectively connected with a permanent establishment of the French resident in the United States. All royalties received by a French resident that would be sourced in the United States by the existing treaty would also be sourced in the U.S. by the proposed protocol. Theoretically, the proposed protocol would slightly expand the category of U.S. source royalties to include royalties paid by a U.S. resident (or a U.S. permanent establishment) for the use of intangible property outside the United States. Thus under the protocol the United States could potentially extend its taxing jurisdiction over royalties paid to French residents. However, since the Code generally does not permit U.S. gross basis tax on such royalties earned by foreign persons (because they are not derived from U.S. sources), no practical effect on U.S. tax liabilities of such persons would result from this change.

On the other hand, the proposed protocol would change the taxing jurisdiction of France over royalty income of U.S. residents, in order to conform the jurisdiction permitted by the treaty with the source rules of internal French law. Under the existing treaty, if the right or property giving rise to such income is not effectively connected with a permanent establishment of the U.S. resident in France, then generally such income is taxable by France only if it is for the use of intangible property in France. Under the proposed protocol, if such royalties are paid to the U.S. resident by a Belgian resident without a French permanent establishment, even for use of the intangible in France, then no French tax would be imposed. By contrast, if the Belgian resident does have a French permanent establishment, and the liability to pay the royalties was incurred by that permanent establishment and the royalty was borne by that permanent establishment, then the proposed protocol would allow France to tax the royalty regardless of whether it was for the use of intangible property in France.

Beneficial owners

The existing treaty limits or prevents source country taxation on certain royalties derived by residents of the treaty countries in certain circumstances. According to the Technical Explanation, it was believed that this language could be interpreted to deny treaty benefits to treaty country residents that beneficially owned royalties derived from sources in the other country, but who received the income through a nominee. In order to clarify that this is not the case, the proposed protocol would amend the treaty so that it would limit (or prevent) source country taxation only in cases where the *beneficial owner* of the royalties is a resident of the other treaty country. Thus, the treaty as amended would provide that where royalties are earned by a beneficial owner who is a resident of one of the treaty countries and the royalties arise in the other country, they may be taxed by the other country at a rate not exceeding 5 percent of the gross amount paid. Similarly, the amended treaty would provide that the source country will not tax royalties derived from copyrights of literary, artistic, or scientific work by a beneficial owner who is a resident of the other country.

Time royalties deemed paid

The proposed protocol would provide that royalties are deemed paid to the beneficial owner at the latest when they are taken into account as expenses. (See discussion of Article V above for a discussion of the parallel rule for interest.) Again according to the Technical Explanation, this rule is not to be construed as requiring one to whom a royalty is owed to pay withholding tax to a treaty country, prior to the time that the royalty is actually paid, in a case where the payor takes the royalty expense into account as an expense before the payor remits withholding tax to that country.

Article VII. Capital Gains

Under the capital gains article of the existing treaty, generally a resident of France or the United States is not taxable by the other country on gains from the sale or exchange of capital assets. One exception to this rule allows taxation by one country of gain of a resident of the other country that is effectively connected with that resident's permanent establishment in the first country. Another exception allows taxation by one country of gain of an individual resident of the other country that is effectively connected to that individual's fixed base in the first country.

The 1986 Act provided that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Act provided that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Consistent with the first of these 1986 Act changes, the proposed protocol would amend the business profits article of the existing treaty to clarify that any income or gain attributable to a permanent establishment of a treaty country resident is taxable in that country even if the payments are deferred until after the permanent establishment has ceased to exist. (See discussion of Article III above.) The proposed protocol would similarly amend the capital gains article to clarify that nothing therein prevents the country in which the permanent establishment is located from taxing the gain permitted to be taxed under the business profits article as it would be amended. As an example of this provision, the Technical Explanation states that installment payments received from the sale of equipment used by a U.S. permanent establishment of a French corporation after the permanent establishment has ceased to exist are "treated under Article 6 (Business Profits) of the Convention."

It is understood that no change to the capital gains article is believed necessary to conform the treatment of gain effectively con-

nected to a fixed base in a treaty country with Code section 864(c)(6) as added by the 1986 Act.

The proposed protocol does not conform the treaty's treatment of capital gains to Code section 864(c)(7) as added by the 1986 Act.

Article VIII. Branch Profits

The proposed protocol would make a number of changes to the existing treaty related to provisions of the 1986 Act enacting the 30 percent branch profits tax (Code sec. 884(a)). The protocol would provide for a maximum 5 percent rate on both the U.S. and French branch profits taxes as applied to corporations of the other country eligible for treaty benefits and would expand the current treaty's exemption from the U.S. accumulated earnings tax for certain French corporations, in order to cover those corporations that would be subject to the U.S. branch tax under the proposed protocol.

Branch profits tax

The 1986 Act imposed branch level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The Act provided that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country or the treaty satisfies certain other criteria. (A bill passed by the House of Representatives and pending in the Senate which includes technical corrections to the 1986 Act amends this requirement to provide that only qualified treaty country residents are entitled to treaty waivers or reductions of the branch profits tax.)

The Act defines a "qualified resident" as any foreign corporation which is a resident of a treaty country if can meet at least one of the following tests. First, any foreign corporation resident in a treaty country will be a qualified resident of that country unless more than 50 percent (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens,[2] or 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded.[3] Third, the corporation may receive qualified resident status if it establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individ-

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[2] The pending technical corrections bill referred to above would amend this requirement so that it would disqualify a corporation owned *50 percent or more* by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens.

[3] The pending technical corrections bill would amend this requirement so that a foreign corporation would also be a qualified resident if wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

uals who are not residents of the treaty country do not use the treaty in a manner inconsistent with the purposes of the treaty rules contained in the Code provisions regarding the branch profits tax.

The proposed protocol would allow the United States to impose the branch profits tax (as opposed to the branch level interest tax (Code sec. 884(f)) on a French corporation that has a permanent establishment in the United States and would allow France to impose its branch profits tax on a United States corporation that has a permanent establishment in France. However, the proposed protocol would allow a reduction in the branch tax rate imposed by the Code on French corporations and, in cases where a foreign corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed protocol would completely eliminate the branch profits tax that the Code imposes on such corporation.

Neither country's tax may be imposed on corporations resident in the other country at a rate exceeding 5 percent. Moreover, the U.S. tax may be imposed only on that portion of the business profits of the French corporation attributable to its U.S. permanent establishment which represents the "dividend equivalent amount" of those profits in accordance with the Code. (Currently that term is defined in Code section 884(b), under which the dividend equivalent amount of business profits attributable to a permanent establishment would generally be the earnings and profits attributable to a U.S. permanent establishment, plus an additional amount representing any decreases in the permanent establishment's "U.S. net equity" and minus an amount representing any increase in the permanent establishment's U.S. net equity.) None of the restrictions on the operation of U.S. or French internal law branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the treaty's limitation on benefits article (Article 24A) as it would be amended by the proposed protocol. As described in the discussion of Article XIII below, the limitation on benefits requirements of the proposed protocol are very similar to, but not identical with, the analogous provisions of the branch profits tax provisions of the Code described above.

Similarly, the protocol would allow France to impose its branch profits tax only on that portion of the business profits of a U.S. corporation attributable to its French permanent establishment and which is included in the base of the French withholding tax in accordance with the provisions of French internal law.

Where a French or U.S. corporation conducts a trade or business in the other country as a member of a partnership, the proposed protocol allows the imposition of the other country's branch profits tax on the portion of the business profits attributable to that trade or business, apparently only if and to the extent that the trade or business carried on through a permanent establishment.

Other taxes

Consistent with the business profits article of the treaty and the branch profits tax provisions of the proposed protocol, the existing treaty exempts French corporations from the U.S. accumulated earnings tax (Code secs. 531-537) in any taxable year unless the cor-

poration is engaged in trade or business in the United States through a permanent establishment at any time during such year. However, the proposed protocol expands this exemption so that it applies to any French corporation that meets the 50 percent ownership test of the limitation on benefits article of the treaty as it would be amended by the proposed protocol, regardless of whether the corporation has a U.S. permanent establishment. Under the existing treaty as it operated prior to the advent of the U.S. branch profits tax, a French corporation with a U.S. permanent establishment had the choice of risking U.S. accumulated earnings tax on accumulations of earnings beyond the reasonable business needs of the permanent establishment, or avoiding additional U.S. taxes on those earnings either by investing the accumulations in the U.S. business or remitting permanent establishment earnings to the head office at no U.S. tax cost. Under the 1986 Act as it would operate in conjunction with the proposed protocol, the U.S. tax-minimizing choices would be narrowed: as before, one choice is to reinvest the earnings in the business of the U.S. permanent establishment with no added tax on those earnings; the other choices—either investing the earnings in other assets in the United States or remitting the earnings to the head office—entail a relatively certain branch profits tax liability.

Prior to the 1986 Act, the Code imposed a withholding tax on a portion of dividends paid by foreign corporations to foreign shareholders if the U.S. effectively connected gross income of the corporation exceeded a 50 percent threshold over a 3-year period (former sec. 861(a)(2)(B)). The existing treaty limited the imposition of this tax on French corporations so that meeting the threshold required the existence of a U.S. permanent establishment and satisfying an 80-percent test rather than a 50-percent test. The 1986 Act prohibited imposition of this tax on corporations not exempt from the branch profits tax. Consistent with this 1986 Act amendment, with the limitation under the proposed protocol of the U.S. branch profits tax on French corporations to cover only their profits attributable to U.S. permanent establishments, with the elimination under the proposed protocol of U.S. sourcing for dividends paid by French corporations, and with the exemption under the existing treaty from U.S. withholding tax on dividends paid by French corporations *without* permanent establishments in the United States, the proposed protocol would delete the treaty's limitation on U.S. withholding from dividends paid by French corporations. (See the discussion of Article IV above.)

Article IX. Relief from Double Taxation

The proposed protocol adds a new exemption from French income tax for certain types of U.S.-related investment income of French residents who are U.S. citizens. The proposed protocol would require France to provide this exemption only upon adequate demonstration by the person claiming the exemption that he or she has complied with his or her U.S. tax obligations. The protocol would also make this demonstration requirement a condition for obtaining the benefit of the existing treaty exemption from French tax for French residents who are U.S. citizens and who visit the United States for purposes of study, training, research, teach-

ing, or gaining technical, professional, or business experience. Finally, the proposed protocol would require France to give a tax credit to its residents for U.S. branch profits taxes paid to the United States in accordance with Article 13 of the treaty as revised by the proposed protocol. (See discussion of Article VIII above.)

The proposed new exemption for U.S. citizens resident in France covers certain U.S. source dividends, interest, and royalties, capital gains from the sale or exchange of capital assets generating such exempt income, and profits and gains derived from transactions on a public U.S. options or futures market (for example, the Chicago Board Options Exchange or the Chicago Mercantile Exchange). In order to qualify for the exemption from French tax, dividends, interest, and royalties must be beneficially owned by the U.S. citizen who is a French resident, and must be derived from sources within the United States as that term is defined in the treaty as amended by the proposed protocol. In addition, the payor of such dividends, interest, or royalties must meet one of the following four descriptions:

A) The United States or any political subdivision or authority thereof;

B) A U.S. legal entity (for example, a corporation or partnership) the principal class of shares or interests in which are substantially and regularly traded on a recognized stock exchange as defined in the limitation on benefits article (see discussion of article XI below);

C) A U.S. corporation the outstanding shares of the voting stock of which was not 10 percent or more owned by the French resident (either directly or indirectly) at all times during the period beginning on the first day of the corporation's taxable year preceding the year in which the income was paid to its owner and ending on the day before the date that payment was made, provided also that 50 percent or more of such stock of the U.S. corporation was not owned by French residents during the same period;

D) A U.S. resident not more than 25 percent of the gross income of which for the prior taxable year (if any) consisted directly or indirectly of income derived from sources outside the United States.

Capital gains beneficially owned by French residents who are U.S. citizens from the sale or exchange of capital assets generating U.S. source income of the kind described above are similarly exempt from French tax. However, these gains will be taken into account for other French tax purposes, namely, the determination of the threshold of taxation (affecting, for example, marginal tax rates at which gains are taxed) applicable in France to capital gains on movable property.

Under the existing treaty, France exempts its residents who are U.S. citizens and who visit the United States for purposes of study, training, research, teaching, or gaining technical, professional, or business experience from tax on certain income from certain services performed in the United States (Articles 17 and 18 of the treaty). The income exempted from French tax is income that would be exempt from U.S. tax if earned by a French resident who is not a U.S. citizen, but is subject to U.S. tax when earned by a U.S. citizen. In order to ensure that this exemption and the new exemption described above serve to prevent double taxation, rather

than all taxation, the proposed protocol conditions the availability of each exemption upon a demonstration by the U.S. citizen claiming the exemption that he or she has complied with his or her U.S. income tax obligations, and upon either receipt by the French Minister of Economy and Finance or his delegate of such certification as he may prescribe, or a request to the Minister for refund of taxes withheld together with the presentation of any required certification.

Article X. Nondiscrimination

The proposed protocol amends the nondiscrimination article of the existing treaty (Article 24) to clarify that that article shall not be construed as preventing the application by the United States of its branch profits tax or the application by France of its withholding tax, as described above in the discussion of Article VIII of the proposed protocol.

Article XI. Limitation on Benefits

The proposed protocol replaces the article of the existing treaty which is intended to limit the benefits of the treaty to persons who are entitled to those benefits by reason of their residence in the United States or France with a new limitation on benefits article modifying existing conditions to eligibility for treaty benefits and containing additional conditions. Unlike the existing article, the article contained in the proposed protocol expressly states that it applies only in cases where the treaty country resident seeking the benefit of the treaty derives income from the country of which that person is not a resident. The principal condition added in the proposed limitation on benefits article is the "base erosion" rule. The base erosion rule in the proposed protocol is similar to provisions in the U.S. model treaty, and its language is very similar to the branch profits provisions of the Code and the 1986 protocol to the U.S. income tax treaty with China. In addition, the proposed protocol (unlike the existing treaty) conditions eligibility for relief from double taxation upon the satisfaction of the requirements of the limitation on benefits article.

The treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and France as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping," and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the resident country

or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

Limitation on benefits under the existing treaty

The existing treaty provides that a person other than an individual (such as a corporation, partnership or trust) is not entitled to the benefits of the treaty unless it satisfies any one of an ownership test, a public company test, or a good business purpose test. Under the ownership test, more than 50 percent of the beneficial interest in the person (in the case of a company, more than 50 percent of the number of shares of each class of shares) must be owned directly or indirectly by any combination of one or more individual residents of France or the United States, citizens of the United States, publicly traded companies, or the governments of the United States or France (collectively, qualifying persons). For example, this provision denies the benefits of the reduced U.S. withholding tax rates on dividends or royalties paid to a French company that is controlled by individual residents of a third country. This rule is not as strict as that contained in the U.S. model, which requires 75 percent ownership, by residents of the person's country of residence, to preserve benefits.

Under the public company test, a company that is a resident of one of the countries and that has substantial and regular trading in its principal class of stock on a recognized stock exchange in the United States or France is entitled to the benefits of the treaty regardless of where its actual owners reside. In addition, any interest that such a company holds is a qualifying interest under the 50-percent ownership test above. The term "recognized securities exchange" means any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, the NASDAQ system owned by the National Association of Securities Dealers, Inc., the French stock exchanges (Bourses de Valeurs) and any other stock exchange agreed upon by the competent authorities of the two countries.

Under the good business purpose test, denial of treaty benefits does not occur if the establishment, acquisition, and maintenance of an entity that is a resident of the United States or France and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the treaty. Accordingly, the provision does not apply if it is shown that there was no treaty shopping motive for forming the company and if its operation did not have as one of its principal purposes the purpose of obtaining the treaty benefits. Thus, the burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming treaty benefits. The Technical Explanation to the proposed protocol provides two examples of situations in which it is intended that this rule applies. The first example is a French company not meeting the ownership or public company tests, but that is engaged in an active manufacturing business in France. According to the Technical Explanation, U.S. source dividends received from a U.S. subsidiary of the French corporation which are attributable to income realized by the subsidiary from sales of products

manufactured by the French corporation would be eligible for the 5 percent rate on direct investment dividends provided by the treaty's dividend article. The second example is a French company not meeting the ownership or public company tests but which (1) holds stocks and securities the income from which is not predominantly from U.S. sources, (2) has widely dispersed ownership, and (3) employs in France a substantial staff actively engaged in trades of stocks and securities owned by the company. The Technical Explanation states that U.S. source investment income earned by the company would be eligible for a reduced rate of U.S. withholding tax under the treaty, but not if all three of the above factors were absent.

The proposed protocol

The proposed protocol replaces the 50-percent ownership test described above with a two part test, incorporating both the existing 50-percent ownership test with one modification, and a so-called "base erosion" test. Under the proposed protocol, a person (other than an individual) which is a resident of one country and derives income from the other country is not entitled to either the benefits of the treaty or relief from double taxation in its country of residence (assuming that person meets neither the public company test or the good business purpose test) unless that resident meets the modified 50-percent ownership test *and* not more than 50 percent of the gross income of the person is used directly or indirectly to meet liabilities (including liabilities for interest or royalties) to persons who are not residents of France or the United States, citizens of the United States, the governments of France or the United States or local authorities thereof, or political subdivisions of the United States. This latter rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. This provision is substantially similar to that in the U.S. model treaty.

As mentioned above, the 50-percent ownership test of the existing treaty is modified in the proposed protocol. Under the latter, qualifying persons include local authorities of France and the United States, and political subdivisions of the United States, as well as the classes of qualifying persons specified in the existing treaty: individual residents of France and the United States, citizens of the United States, publicly traded companies, and the governments of France and the United States.

It appears that any corporation that would satisfy the limitation on benefits article of the proposed treaty would generally also meet the definition of "qualified resident" for branch profits tax purposes in the Code.[4] That would not have been the case had the protocol not introduced the base erosion rule. However, some semantic differences remain. For example, a French corporation qualifies for treaty benefits under the protocol if there is substantial and regu-

[4] Certain differences between the two tests are eliminated under the pending bill to make technical corrections to the 1986 Act.

lar trading of its principal class of stock on a recognized stock exchange, while that corporation would not meet the 1986 Act's public company test unless such company's stock were *primarily* traded on an established securities market (or the corporation were wholly owned by another corporation whose stock were primarily so traded). It may be that, for practical purposes, those tests could be interpreted in substantially the same fashion. Also, although it is unlikely, a French corporation that met the good business purpose test might conceivably fail whatever tests the Secretary promulgated under Code section 884(e)(4)(C).

Also as mentioned above, the limitation on benefits article in the proposed protocol, unlike the limitation on benefits article in the existing treaty, provides that failure to meet the ownership test or the base erosion test will mean that a treaty country resident (other than an individual) would not be entitled to relief from double taxation in the residence country. According to the Technical Explanation, this provision affects the eligibility of French residents (other than individuals) for relief from double taxation granted by France, but it has no practical effect on relief from double taxation granted by the United States. Under the existing treaty, the United States generally avoids double taxation of business and investment income of its residents through the foreign tax credit mechanism of the Code. Furthermore, Article 22 of the treaty (which is not amended by the proposed protocol) provides that the provisions of the treaty shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of one of the parties in the determination of its tax. Thus residents of the United States are entitled to foreign tax credits for certain French taxes regardless of the treaty as modified by the proposed protocol.

French residents, on the other hand, are generally not entitled to relief from double taxation under French internal law unless the right to that relief is contained in a treaty. Consequently, under the proposed protocol, French residents (other than individuals) that meet neither the ownership/base erosion test, the public company test, nor the good business purpose test and that derive income from the United States will not be eligible for foreign tax credits against, or exemptions from French taxes on that income.

Finally, the limitation on benefits article of the proposed protocol (unlike that of the existing treaty) states expressly that it applies only to a person that derives income from the other contracting state.

Article XII. Provisions for Implementation

The proposed protocol would add a new Article 25A to the existing treaty authorizing the competent authorities of the United States and France to prescribe rules and procedures, jointly or separately, to determine the mode of application of the treaty provisions.

The Secretary of the Treasury, the competent authority of the United States, already possesses administrative authority to implement the treaty through regulation, revenue rulings, revenue procedures, and other publications. The Technical Explanation states that the purpose of the new Article is to permit explicitly the de-

velopment of certification procedures for determining eligibility for treaty benefits, not to modify the substance of those benefits.

As described above, Article IX of the proposed protocol, which provides new exemptions from certain French taxes for certain U.S. source investment income and related gains earned by U.S. citizens resident in France, conditions the exemption on both a demonstration by the income recipient that he or she has complied with U.S. income tax obligations, and either (1) receipt by the French Minister of Economy and Finance or his delegate of such certification as he may prescribe, or (2) the making of a request to the Minister for a refund of withheld taxes, accompanied by such certification as may be required. Thus, new Article 25A of the treaty provides the Minister with express authority to prescribe (alone or jointly with the U.S. Treasury) procedures for, and the required content of, the certification called for under Article IX of the proposed protocol. In addition, new Article 25A provides authority more broadly to develop certification procedures to determine, for example, that a taxpayer claiming a reduction or elimination of tax liability pursuant to the treaty on income derived from a treaty country is a resident of the other country, that the taxpayer meets the requirements of the limitation on benefits article, that a tax for which a credit is claimed pursuant to the relief from double taxation article has actually been paid, or that any other predicate to the entitlement to a treaty benefit is met.

Article XIII. Entry into Force

The proposed protocol will enter into force upon the date of receipt by each party of notification from the other that the constitutional procedures necessary for the proposed protocol to enter into force have been satisfied. In case notifications are received on different dates, the date of receipt of the last such notification will be the date of entry into force. Once in force, the provisions of the protocol relating to taxes withheld at source will apply to amounts payable on the first day of the second month following the date of entry into force. The provisions relating to the U.S. branch profits tax and French withholding tax on profits will apply to profits realized in taxable years ending on or after the date of entry into force. The provisions regarding the exemption from French tax for certain U.S. source investment income and related gains earned by U.S. citizens resident in France will apply retroactively to income described in those provisions derived on or after January 1, 1988. The remaining provisions of the proposed protocol will apply to taxable years beginning on or after the date of entry into force.

Article XIV. Termination

The proposed protocol will remain in force as long as the U.S.-French income tax treaty remains in force. The present treaty may be terminated by either country giving notice of termination to the other through diplomatic channels at least six months before the end of any calendar year.

Exchange of Notes

Contemporaneously with the signing of the proposed protocol on June 16, 1988, France and the United States exchanged notes to clarify that nothing in the source rule paragraph of the interest article of the treaty, as it would be amended by the proposed protocol, shall be understood to prevent or limit the application by a contracting state of its internal law, or its treaty with a third state, with respect to interest paid by a permanent establishment located in the contracting state to any resident of a third state. The internal laws referred to in the notes are (1) in the case of the United States, those Internal Revenue Code provisions that impose tax on interest paid by a foreign corporation's trade or business in the United States, as described in Code section 884(f)(1)(A), and (2) in the case of France, articles 119 bis and 125A of the Code General des Impots. The notes clarify, for example, that the United States may impose its 30 percent withholding tax on interest paid by a U.S. branch of a French corporation to a resident of a third country, assuming that the interest does not qualify for an exemption under the Code or an exemption or rate reduction in a treaty that the third country has with the United States.

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